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The Free Trade Deal:

Shall We [illegible]sake the Bird in the Hand?

by

Richard G. Lipsey and Robert C. York

The Canada-U.S. Free Trade Agreement is a pivotal issue in the current federal election campaign. How this issue is decided will influence the country's trade and investment patterns well into the twenty-first century.

This issue of *Trade Monitor* — which is based on a submission the Institute made to the House of Commons legislative committee on Bill C-130 on July 21, 1988, and which is the latest in a long history of Institute publications on Canadian trade policy — explains the Institute's reasons for supporting the current Agreement. Full treatment of each of the topics discussed here requires a lengthier document, for which we refer readers to Richard G. Lipsey and Robert C. York, *Evaluating the Free Trade Deal: A Guided Tour through the Canada-U.S. Agreement* (Toronto: C.D. Howe Institute, 1988).

Canada's Trading Environment

Degree of exposure. Nearly 30 percent of Canada's national income and employment is derived from exports. Allowing for indirect effects, something like 50 percent of Canada's output and employment depends on exports. This enormous magnitude makes trade policy important for *any* Canadian government. Current policy is to pursue access to foreign markets on two fronts: the Canada-U.S. Agreement and the Uruguay Round of negotiations under the General Agreement on Tariffs and Trade (GATT).

Globalization. The globalization of the world's economy is accelerating. Not only do foreign multinationals locate in Canada, but an increasing number of Canadian firms have major locations abroad. Over the past several years, Canadian direct investment in the United States has been growing three times as fast as U.S. direct investment in Canada. Manufacturing firms increasingly source their parts from many countries and assemble them in several countries. Banks are globalizing. Aided by the appreciation of the yen, Japanese banks, which accounted for just one of the top ten banks at the beginning of the 1980s, today have seven of the top ten, which compete on a global basis with U.S. and European banks. In today's globalizing world, it is difficult to stand

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still; instead, it is often a case of adapt, or lose to tough international competition.

Protectionism. Since the end of the Second World War, world trade has grown steadily as a result of major tariff reductions coordinated by the GATT. Trade barriers — often in the form of so-called nontariff barriers — have been rising over the past decade. This is a matter of serious concern for all trading countries.

Regional trade liberalization. The movement to liberalize trade through regional agreements now covers 71 countries, including all the advanced industrial countries except Japan and Canada. This movement will not go away if Canada refuses to take part. Some regional groupings have succeeded better than others, but Canada would be unique if, given the chance, it said no to its most important trading partner.

The Agreement in Perspective

The Agreement is not a new initiative for Canada. Rather, it comes close to completing a policy begun in the late 1930s, when Canada signed two trade-liberalizing pacts with the United States, and entrenched in 1947, when Canada became a member of the GATT. The Agreement is founded on GATT principles. Many clauses — including some that have come under severe criticism — merely reconfirm, or tighten up, obligations Canada has already undertaken by virtue of its membership in the GATT.

The Agreement's bilateral aspect may have political and symbolic consequences. However, since about 80 percent of Canada's foreign trade is with the United States, it is hard to believe that the economic consequences of Canada-U.S. trade liberalization will differ significantly from those of previous multilateral, GATT-negotiated trade liberalizations, *all of which were adopted without nationally noticed dislocation and carried through without serious loss of sovereignty* (beyond what was accepted in trade).

Some observers worry about the high dependence of Canadian exporters on the U.S. market. This dependence is partly due to Canadians' great success in penetrating one of the few really open and expanding markets of the 1980s. Furthermore, if Canadian producers cannot succeed in free competition in the U.S. market, they are unlikely to succeed in the more competitive offshore markets. Indeed, rationalizing costs on the basis of the large North American market may be an important step toward penetrating these other markets.

The 71 countries now in regional trade-liberalizing agreements have not been beset by the disasters that opponents of the Agreement have predicted: enormous environmental deterioration, diminishing control of acid rain, the forcible removal of water from an unwilling country by its thirsty trading partner, and the end of energy conservation policies. Just as such horrors have not plagued other countries in other regional agreements, there is no rational argument that they should materialize out of this Agreement, which is primarily a commercial agreement about market access.

The Agreement and Access

Whatever its shortcomings, the Agreement provides for a major liberalization of trade and for the removal of many trade irritants.

Access for Goods

First, it increases access in 18 identifiable ways, running from the complete removal of tariffs on all trade in goods to the easing of border crossings for business and service personnel, whose frequent harassment at the border is a significant nontariff barrier.

Second, it makes access to the U.S. market more secure in eight different ways, two of which are important gains. It places severe constraints on emergency actions to stop surges of Canadian exports to the United States. And the Agreement's prohibition of quota restrictions ends their threatened use by the United States as a means of persuading Canadian firms to restrain their exports through voluntary export restrictions, as in the case of specialty steel.

Third, although it falls short of many people's expectations, the Agreement incorporates dispute settlement mechanisms that are superior to those available in the GATT. Disputes on the operation of the Agreement are to be overseen by a cabinet-level committee and referred, if necessary, to a binational arbitration panel. A bina-

tional panel will also replace judicial review of both countries' domestic fair-trade laws. This binational appeal process is superior to the status quo for two reasons: a fixed timetable shortens the appeal procedure, and the possibility of binational scrutiny should increase the objectivity of the domestic decisionmaking process.

Fourth, the Agreement promises future increases in security of access by mandating negotiations, over the next five to seven years, on a code for subsidy and antidumping procedures. Opponents have ridiculed this achievement, which certainly falls well short of getting an immediate agreement on these issues. It is difficult to see, however, how Canada could ensure such consultations if it rejects the Agreement.

Access for Services

The Agreement frees up trade in covered services — commercially traded services such as business consulting and insurance — by virtue of its granting them the right of establishment and national treatment. The Agreement exempts noncovered services, which include most government-produced services such as hospitals, education, and child care.

Trade in services has become such an increasingly important component of bilateral trade that its inclusion in the Agreement was highly desirable. This pathbreaking part of the Agreement may set the tone for further multilateral GATT negotiations.

Failures on Access

Canada lost out on some access issues, just as the United States lost out on others. Here is where Canada might have gotten more.

Canada did not get free trade in transportation, which includes shipping and trucking.

Canada did not get free trade in most government procurement. The U.S. procurement market is worth C$700 billion per year, and Canada could have gained a sizable chunk of this under free trade.

Canadian financial firms did not get the same access to the U.S. market as was granted to U.S. firms in the Canadian market. What they did get was a promise of national treatment when the United States opens up its own highly regulated market to more internal competition.

Canada did not get an agreed code on countervail and antidumping procedures. This was particularly unfortunate on antidumping, since both countries concede that they use antidumping laws as nontariff trade barriers. A long period of negotiations and education is probably needed, however, before they can agree on a list of subsidies that will be exempt from antidumping laws and on those that will risk such sanctions. We reaffirm the view expressed in an earlier study [Richard G. Lipsey and Murray G. Smith, *Taking the Initiative: Canada's Trade Options in a Turbulent World* (Toronto: C.D. Howe Institute, 1985)], that it was unlikely that an agreed code on subsidies could have been negotiated in the timeframe of the original negotiations. Postponing this part of the Agreement for five years, therefore, was not a defeat but a realistic appreciation of the difficulties involved.

Conclusion on Access

On grounds of access to the U.S. market for Canadian exporters of goods and services, the Agreement must be regarded as a major success. Everyone would have liked more. But the Agreement offers more in one fell swoop than any of the world's many other regional trading agreements have managed to develop over the several decades of their existence.

The Cases For and Against

The case for accepting the Agreement is that it provides major improvements in access, and in security of access, to the U.S. market for Canadian exporters while not seriously compromising Canada's policy independence in other directions.

Those who would reject the Agreement can be divided into more than one group.

Many would reject the Agreement because they are opposed to further trade liberalization. This group includes those who wish to erect more trade barriers than Canada now has, and those who fear the harm they allege the Agreement will do to particular groups such as women or those employed in "trade-sensitive" industries. These

are, however, risks that are associated with any liberalization of trade.

Some would reject the Agreement because it does not offer Canada enough by way of access to the U.S. market. Since the judgment of neutral trade experts is that the Agreement offers more on access than does any of the many other regional trade-liberalizing pacts, including the European Community and the European Free Trade Association, this case seems to be the counsel of unreasonable perfection.

Some would reject the Agreement because its provisions on dispute settlement, particularly for resolving disputes on antidumping and countervail cases, are inadequate. There is no doubt that Canada did not get everything it wanted here. There is also no doubt that the Agreement provides for a clear improvement on existing procedures. Opinion varies, however, on the size of the improvement. The Agreement also mandates negotiations to improve the dispute settlement mechanism over the next five to seven years. Critics might be asked to provide a substitute plan on how to get further than this deal goes on dispute settlement. We are not aware of a plan that would meet even the minimal requirement of being a starter in international negotiations.

Finally, some accept the case that the Agreement provides a major increase in both access and security of access but would reject it nevertheless, on the grounds that it gives away more on other aspects than is justified by what it achieves on access. This is probably the most generally accepted case for rejecting the Agreement. To explain why we do not accept this position, we need to look at what Canada actually has given up and at the constraints the Agreement may place on future policies, independent of its precise contents. In the following sections, we look at the major places where such allegations have been levied against the Agreement.

Energy

What Canada gains. The Agreement works to the advantage of the energy-producing provinces by allowing them free access to the U.S. market. Without such access, the full, vast potential of Canada's frontier energy reserves is unlikely to be developed. Undeveloped, these reserves contribute neither to Canada's energy security nor to its economic well-being. The United States can no longer use national defense as an excuse for restricting imports of Canadian energy, nor can it establish quotas or place total restrictions on such Canadian energy exports as electricity and uranium.

What Canada retains. The Agreement does not spell the end to independent Canadian energy policies. It leaves Canada free to follow all energy-conserving, or energy-using, policies except those that discriminate between domestic and foreign producers or consumers. *Canadian governments can control the rate of extraction of an exhaustible natural resource such as oil or gas; they can tax producers to appropriate resource rents; they can subsidize consumers (using such methods as tax remissions for Canadian energy users); and they can use energy resources for industrial advantage.*

What Canada gives up. In return for getting secure access to the U.S. energy market, Canada has made two promises.

First, it will not use government decree to impose a price for energy sold to the U.S. market that is higher than the price of energy sold in the Canadian market.

Second, in times of crisis — declared at Canada's discretion — if Canada wishes to interrupt normal commercial agreements, it will share the available supplies with the United States. It is important to emphasize that this is a general arrangement to which Canada is already committed in the GATT and under the International Energy Agency, in the case of oil. The outcry in Canada is based partly on a misunderstanding of the sharing agreement. Many have argued, for example, that if Canada sells energy to the United States now, it can never stop selling energy in the future. This is not so. If the pattern of Canadian demand changes slowly at rates typical of those caused by economic growth, there is nothing in the Agreement to stop Canadian firms from reacting by selling a higher proportion of output in Canada while selling a lower proportion to the United States. In fact, the sharing provision is activated only in the case of a genuine emergency, at which time a Canadian government may wish to override *existing* commercial contracts.

The balance of the Agreement. The energy chapter of the Agreement is a package that must be judged as a whole. There is no point in Canada's advocating retention of its gains if it is not also prepared to make a few concessions. Canadians must decide if the gains associated with significantly improved and more secure access for Canadian energy exports to the United States are worth the price of providing a greater degree of security of supply to U.S. consumers. In our view, the removal of trade barriers will enhance the security of energy supply of both countries by encouraging development of Canadian energy that would not otherwise be economically viable.

Investment

The investment chapter mainly restates the two countries' GATT obligations.

What Canada gives up. Canada has agreed to raise the threshold for review of U.S. direct takeovers of Canadian firms from $5 million to $150 million. This will leave three-quarters of nonfinancial investment in Canada still subject to review. It also leaves Canada asymmetrically treated relative to the United States, which will not be able to review any direct takeovers of U.S. firms by Canadians once the Agreement is in place.

Canada will also no longer demand some performance requirements of U.S. firms that take over Canadian firms. Insofar as they relate to exports and imports, these requirements were not consistent with Canada's GATT obligations in any case. Insofar as they relate to other matters, Canada's giving them up constitutes a clear, but minor, constraint on future policy, the importance of which depends on how one views the international investment scene.

What Canada gains. The United States has abandoned its claim to be treated equally. It now accepts that the Canadian government can scrutinize takeovers of U.S. firms. It also guarantees full national treatment of Canadian investment in the United States, whatever discriminatory laws that country subsequently may adopt against investment from other countries.

The balance of the Agreement. In our view, the investment part of the Agreement is a good deal.

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Richard G. Lipsey and Robert C. York, the authors of this issue, are Senior Policy Advisor and Policy Analyst, respectively, at the C.D. Howe Institute.

For further information, please contact: Barry A. Norris, Director of Publications, C.D. Howe Institute, 125 Adelaide Street East, Toronto, Ontario M5C 1L7; telephone (416) 865-1904. All Institute publications can be obtained from: Prentice-Hall Canada Inc., 1870 Birchmount Road, Scarborough, Ontario M1P 2J7.

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In return for raising the level of review and abandoning performance requirements, both of which are minor policy tools at best, Canada gets complete national treatment of its investment in the United States. To get these national treatment rules in place before any U.S. backlash from the rapidly rising stock of foreign investment in that country may turn out to be one of the most farsighted measures in the whole Agreement.

Water

The Agreement's tariff schedule on water, which is copied exactly from the GATT, affects only the Canadian tariff on bottled water from the United States. It does not cover water diversion and/or interbasin transfers of water, as decades of GATT precedents attest.

- There is no precedent for flowing river or lake water to be considered *as a commodity* by any international, commercial trade agreement. This means that no such agreement has ever covered water.
- There is nothing in the GATT, on which the Agreement is based, that forces Canada to sell its water, or any other good for that matter.

The Auto Pact

The auto pact has served both countries well — and Canada particularly so. But prior to the Agreement, it had become unstable and vulnerable to U.S. countervail because of Canadian programs aimed at attracting overseas producers through duty remissions.

The Agreement does not weaken the auto pact in any serious way; to the contrary, it seems to make the auto pact even more favorable to North American producers than it now is. Two improvements are clear: the Agreement removes the threat of U.S. countervail proceedings and, since the auto pact itself is incorporated into the Agreement, it becomes less vulnerable to abrogation, or further amendment, than when it stood alone.

Culture

The Agreement completely exempts the cultural industries. Nonetheless, debate has centered around Article 2005.2, which allows the United States to retaliate to "equivalent commercial effect" against any new Canadian cultural policy. But there is nothing new here: the article merely formalizes the status quo, under which the United States — and any other foreign country that is a GATT signatory — can, and has, retaliated against Canadian cultural policies.

Under the terms of the Agreement, U.S. retaliation is subject to review by the binational dispute settlement panel. For such retaliation to be allowed, the panel must find the Canadian policy to be inconsistent with the terms of the Agreement, and it must judge the retaliation to have no more than "equivalent commercial effect." This represents a considerable improvement over the status quo, whereby the United States retaliates unilaterally. U.S. influence over Canadian cultural policies is thereby reduced.

Social Services

In spite of its clear wording, many people believe that the Agreement somehow covers noncovered services. For example, in spite of popular belief, provincial governments can continue to regulate new child-care operations as they choose. The provinces can decide on licensing commercial child-care centers, U.S. or Canadian, while provincial regulators can establish discriminatory standards. Furthermore, Canadian governments can offer subsidies to domestic child-care operations and not to U.S. operations. In short, free trade will not constrain Canadian policy options for such noncovered services in any significant way.

Critics have argued that Article 2011, on "nullification and impairment," leaves Canada open to invasion by U.S. enterprises that Canadians might wish to exclude — private U.S. child-care firms being an example. This concern is unfounded. The United States can invoke dispute settlement procedures and, in the end, take actions to cause equivalent loss to Canada if Canada takes actions to nullify any benefit *that could reasonably be expected to accrue to the United States from the Agreement.* Since *no* noncovered service has benefits that U.S. firms could reasonably expect to follow from the Agreement, they have no conceivable recourse to this clause.

Sovereignty

There are two ways in which countries can lose sovereignty through an international trade agreement. First, they may bargain it away. Second, the agreement may set loose forces — so-called harmonization pressures — that constrain future policies even though they are covered in the agreement itself. Critics of the Canada-U.S. Agreement have asserted, without evidence or support from economic theory, that it would force harmonization of policies ranging from tax rates to unemployment insurance. We disagree.

- Throughout history, rich countries have traded profitably with poor countries, and high-spending countries have traded profitably with low-spending countries. The global evidence is clear: *free trade is not the enemy of diversity in social policy.*
- By 1986, about 80 percent of the tariff protection that Canadian industry received in 1935 had been removed. During that time, Canadian social and economic policies evolved along lines different from those in the United States. No one has bothered to explain how the very policies Canada evolved while removing 80 percent of its tariff protection could suddenly be threatened by removal of the remaining 20 percent. If liberalizing trade really caused policy harmonization, then

Canadian and U.S. policies should have been increasingly harmonized since 1935.

- Strong harmonizing pressures always exist on the social and economic policies of any two countries between which labor and capital can move. If tax rates in Canada exceed those in the United States, some Canadian citizens, and firms, may be induced to move to the United States whether tariffs are 10 percent or zero. *These incentives depend mainly on the ease with which people and firms can relocate — which the Agreement does not alter — rather than the ease with which goods and services can be traded — which it does alter.*
- A broadly based social policy that increases business costs, as Canada's unemployment insurance does, brings into play a compensating change in the exchange rate. For example, if the federal government wished to introduce a new measure that would raise all Canadian business costs by 10 percent, this would not destroy the competitive position of Canadian exporters. Instead, it would reduce the exchange rate by 10 percent, while leaving their international competitiveness unchanged.

The Alternatives

If Canada turns down the Agreement, what trade options are left? First, the GATT by itself is not a full alternative. True, the current GATT Round will provide some welcome increase in market access. But the Agreement does things that the GATT is unlikely to do: it removes many trade irritants; it provides for free trade in energy; it constrains the use of such nontariff trade barriers as quota restrictions and emergency actions — which were used, for example, against shakes and shingles; and it provides a binding dispute settlement mechanism that the United States has been reluctant to offer to its trading partners and that it will not offer through the GATT.

Many have argued that rejection will result in the negotiation of a new and better agreement. Yet Canadian negotiators did pretty well this time around. If Canada goes back to the United States and says it wants to do better, there is a danger that it will end up doing worse, particularly on such issues as culture and review of takeovers. There are many myths about the Agreement's contents, but few critics have been able to identify places where Canada could do better. New talks would be severely constrained by political pressures from firms and industries that will lose from trade liberalization and that are now fully alerted to its consequences.

Could Canada negotiate a series of sectoral bilateral agreements similar to the auto pact? It tried, and failed, to do so in 1984–85. Furthermore, such agreements violate GATT principles and are unlikely to be accepted as special cases, as was the auto pact.

Conclusion

Supporters and opponents of the Agreement obviously care passionately about Canada's future, and no one needs to apologize for their strong emotions. What has become hopelessly confused in the debate, however, is passion about ends and passion about means.

Those who let their passions about the goals of any policy cloud their dispassionate judgments about the appropriate means to achieve their goals are likely to fail to achieve their ultimate objectives. Although Canadians are right to be emotional about being, and staying Canadians, we owe it to ourselves to be rational in assessing the best ways to do so.

We believe history will judge this Agreement as offering Canada preferential access to one of the world's richest and most dynamic markets: the United States. This access will help Canadian firms generate the wealth that maintains our high relative living standards, and that is available for redistribution through egalitarian social policies.

Canada is being buffeted by global changes. This Agreement is one part — albeit a key one — of Canada's reactions. Much more than just the Agreement is needed, however. Enlightened policies concerning science, education, and industrial change are also required if Canada is not to fall behind in global competition. If the Agreement keeps Canadian policy looking outward, it will have done its job, irrespective of the specific gains that it undoubtedly achieves. To reject the Agreement is to give up major gains in market access and to risk turning Canadian policies in the wrong direction — away from accepting the new realities of globalization and toward the now-obsolete inward-looking policies of the 1970s.

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